1Q 2025

Investment Highlights

Western Asset US High Yield Sector

Western Asset — A Franklin Templeton Company

This is a marketing communication.

Key Takeaways

- *The Bloomberg US High Yield 2% Issuer Cap Index returned 1.00% in the first quarter.*
- *Spreads widened by 60 bps in the first quarter to 347 bps and the YTW increased to 7.73%.*
- *Both CCC and B rated bonds underperformed the index, returning -0.44% and 0.74%, respectively, while BB rated bonds returned 1.49%.*
- *High-yield issuance totaled $68.3 billion for the quarter (39% higher QoQ and 22% lower YoY).*
- *High-yield funds saw inflows of $7.6 billion for the quarter (compared to inflows of $0.8 billion in 4Q24 and inflows of $4.5 billion for the same period a year ago).*
- *We are still seeing opportunities in rising-star candidates and will selectively utilize the primary market at attractive concessions.*
- *We maintain a deep bias to cyclicals given strong fundamentals and attractive yield pickup versus noncyclicals, along with key overweight positions to financials and E&P companies within the energy sector.*

Market Review

During the first quarter, US Treasury (UST) yields fell and the yield curve bull-steepened during a risk-off period. The S&P 500 Index declined and credit spreads widened. The S&P 500 posted its worst quarterly performance since 2022, and the significant market decline was largely attributed to escalating trade tensions and economic uncertainties.

Diverging signals in the market between “hard data”—quantifiable metrics—and “soft data,” which includes surveys and sentiments, persisted throughout the quarter. Hard data (retail sales, durable goods orders and the unemployment rate) suggests that the economy remained resilient. However, several surveys indicated that policy uncertainty was weighing heavily upon consumer and business sentiment, which could lead to slower activity in the coming months. Policy uncertainty remained elevated as the US announced that 25% tariffs on imports from Mexico and Canada (though a one-month reprieve for most goods was announced soon thereafter), an additional 10% tariff on Chinese imports, a 25% tariff on steel and aluminum imports and a 25% tariff on auto imports, would become effective in early April, when reciprocal tariffs were also scheduled to be announced.

In the US, job growth showed an upward trend, with nonfarm payrolls increasing by 151,000 jobs in February, up from a downwardly revised 125,000 jobs in January. The three-month payroll average of 200,000 jobs was above the fourth-quarter average of 182,000 jobs, which included weak numbers in October due to a severe storm and a labor strike. The unemployment rate remained steady at 4.1%. Inflation data was mixed; over the last three months, core Consumer Price Index (CPI) data year-over-year (YoY) declined from 3.30% to 3.10%, while the Core Personal Consumption Expenditures (PCE) Price Index targeted by the Federal Reserve (Fed) remained steady at 2.80%, indicating persistent inflationary pressures.

The Federal Open Market Committee (FOMC) maintained the target range for the fed funds rate at 4.25% to 4.50% at both its January and March meetings. The post-meeting statement in March announced that the monthly pace of UST balance sheet reduction would decrease from $25 billion to $5 billion beginning in April, while the cap on agency debt and agency mortgage-backed securities (MBS) would remain unchanged at $35 billion. During the press conference, Fed Chair Jerome Powell described the economy as “strong overall,” but noted that recent policy changes in trade, immigration, fiscal policy and regulatory policy complicate the reliability of near-term forecasts.

Within the high-yield market, spreads widened by 60 basis points (bps) to end the first quarter at 347 bps, based on the Bloomberg US High Yield—2% Issuer Cap USD Unhedged Index. The yield-to-worst of the index increased to 7.73%. Both CCC and B rated bonds underperformed the index, returning -0.44% and 0.74% respectively, while BB rated bonds returned 1.49%. The broad index returned 1.00% during the period. The top-performing industries were REITs and banking, while transportation and technology were the worst-performing sectors. High-yield issuance totaled $68.3 billion for the quarter, 39% higher quarter-over-quarter (QoQ) and 22% lower YoY. High-yield funds saw inflows of $7.6 billion for the quarter (compared to inflows of $0.8 billion in 4Q24 and inflows of $4.5 billion for the same period a year ago), according to JPMorgan.

Outlook

Proposed tariffs and other policy changes from the new US administration have created uncertainty and volatility in financial markets. Global growth is expected to slow given the heightened uncertainty but should remain solidly in positive territory. US growth is downshifting due to a myriad of factors: uncertainty over tariffs, waning benefits from immigration and reduced government spending, among others. A significant fiscal boost from European defense and Germany infrastructure spending should support eurozone confidence and growth, providing some relief from tariff-related uncertainty. In China, deflationary pressures remain and confidence is weak amid property market concerns, but sentiment is improving with fiscal stimulus and policy easing.

The disinflationary trend may be interrupted as tariffs and retaliatory actions are implemented, but we expect inflation to move lower again over the longer term. Monetary policy remains restrictive. We expect central banks will continue to cut rates further in 2025. The Fed remains well positioned to provide support if the US economy falters. Public debt levels continue to rise and yield curves may steepen given concerns over fiscal policies globally. We see pockets of opportunity in DM rates in Europe, the UK and Australia. While the overall uncertainty in the market environment necessitates caution, we do see some longer-term value opportunities in EM local currency debt. Spread sector fundamentals remain supportive, but valuations reflect those fundamentals and credit spreads persist at below historical averages. We continue to find opportunities within spread sectors and related securities while remaining tactical. DM duration provides useful diversification.

Within high-yield, the potential for total returns at yields approaching double digits remains attractive compared to equity and other higher-volatility alternatives given the current macro backdrop. Today's spreads offer a material premium in excess of default risk. Our expectations for default rates are similar to last year—about 4% on an issuer-weighted basis and 1%-2% less on a par-weighted basis. Leverage and interest coverage ratios for high-yield issuers have shown resilience, with healthy balance sheets and conservative management team behavior evident as growth slows. From a technical perspective, we expect continued demand to persist from both institutional and retail investors as they search for steady income generation in their portfolios. This recent bout of heightened volatility induced by an aggressive approach to trade policy by the Trump administration has only made the risk/reward case stronger for an actively managed allocation to below-investment-grade credit. We are still seeing opportunities in rising-star candidates and will selectively utilize the primary market at attractive concessions. In terms of industry positioning, we maintain a deep bias to cyclicals given the yield pickup versus noncyclicals and the strong fundamentals we are seeing there, along with key overweights to financials and E&P within energy.

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All investments involve risks, including possible loss of principal. Fixed-income securities involve interest rate, credit, inflation, and reinvestment risks; and possible loss of principal. As interest rates rise, the value of fixed-income securities falls. International investments are subject to special risks, including currency fluctuations and social, economic and political uncertainties, which could increase volatility. These risks are magnified in emerging markets. Asset-backed, mortgage-backed or mortgage-related securities are subject to prepayment and extension risks. High yield bonds are subject to greater price volatility, liquidity, and possibility of default.

The **Bloomberg US High Yield 2% Constrained Index** is a component of the U.S. Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging market countries. It is not market capitalization-weighted; each issuer is capped at 2% of the index.

Bloomberg US High Yield—2% Issuer Cap USD Unhedged Index is an issuer-constrained version of the flagship US Corporate High Yield Index, which measures the USD-denominated, high yield, fixed-rate corporate bond market. The index follows the same rules as the uncapped version, but limits the exposure of each issuer to 2% of the total market value and redistributes any excess market value indexwide on a pro rata basis.

The **Consumer Price Index (CPI)** tracks prices for a basket of more than 80,000 goods and services.

Credit quality is a measure of a bond issuer's ability to repay interest and principal in a timely manner. The credit ratings discussed are based on a security's rating as provided by Standard and Poor's, Moody's Investors Service and/or Fitch Ratings, Ltd., and they typically range from AAA (highest) to D (lowest), or an equivalent and/or similar rating. The credit quality of the investments in a fund's portfolio does not apply to the stability or safety of the fund. These ratings are updated monthly and may change over time. Please note that the closed-end funds have not been rated by an independent rating agency. Investment-grade bonds are bonds t hat are rated Aaa, Aa, A and Baa by Moody's Investors Service and AAA, AA, A and BBB by Standard & Poor's Ratings Service, or that have an equivalent rating by a nationally recognized statistical rating organization or are determined by the manager to be of equivalent quality. A below-investment-grade bond or high-yield security has a rating of BB or lower; it pays a higher yield to compensate for its greater risk.

The **Fed Funds Rate** is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve Banks) with each other overnight.

Gross domestic product (GDP) is an economic statistic that measures the market value of all final goods and services produced within a country in a given period of time.

High-yield bonds possess greater price volatility, illiquidity and possibility of default.

Investment-grade bonds are generally rated BBB and above.

The **S&P 500 Index** is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S.

Spread refers to the difference between Treasury securities and non-Treasury securities of similar maturity but different credit quality.

Summary of Economic Projections are released by the Federal Reserve four times a year. SEP features the Federal Open Market Committee (FOMC) participants' projections for GDP growth, the unemployment rate, inflation and the appropriate policy interest rate.

U.S. Treasuries are direct debt obligations issued by the U.S. government and backed by its "full faith and credit." The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

Yield to worst (YTW) is based on a portfolio's current holdings on one specific day, is gross of all portfolio expenses, and is calculated based on assumptions that prepayment occurs if the bond has call or put provisions and the issuer can offer a lower coupon rate based on current market rates.

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